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GUEST COLUMN

The re-emergence of growth investing

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Investors are always searching for superior long-term returns.

While growth and value investing have each outperformed at different times for a variety of reasons, long-term investors concentrating on growth companies have generally had superior returns.

Let's begin by defining growth and value investing.

Growth investors focus on companies that exhibit superior revenue and earnings growth. These companies operate in attractive industries and most have strong balance sheets.

Value investors typically invest in companies that can be purchased at a low price-to-earnings ratio and have a history of growing earnings at a single-digit rate. Many times these companies have struggled to grow revenues and earnings, and frequently their balance sheets reflect substantial amounts of debt.

Since 1988, the **S&P Barra Growth Index** has outperformed the **S&P Barra Value Index**. This 17-year period includes two economic recessions and expansions, several interest rate policy changes, an extremely strong bull market, and the second-worst bear market in 100 years. Despite its long-term record, growth investing has been out of favor for the last five years. The bull market of the late 1990s pushed growth stock valuations to all-time highs, which were corrected during the 2001 economic recession and concurrent bear market.

As this economic expansion ages (it is now in its third year), the investment environment should once again favor growth company investing. A steadily growing economy is generally a good environment for growth companies, while value investing often outperforms in economic recessions and in the early stage of recoveries. The **Federal Reserve** is nearing the end of a series of interest rate hikes that should slow the growth rate of the economy to a moderate and sustainable rate. The economic environment we are entering is similar to the mid 1990s, a period in which growth stocks outperformed value stocks.

Strong earnings growth and attractive valuations are the two factors that will support the re-emergence of growth investing. Growth companies are expected to grow earnings at double-digit rates, while value companies will be increasing earnings at a single-digit rate. That is a significant change from the past five years, when value companies in the energy and commodity industries grew earnings at a rate far superior

to that of most growth companies.

Turning to the question of valuation, growth companies are now less expensive than value companies when measured by their price-to-earnings ratios and growth rate ratios. As an example, Olathe-based **Garmin**, a Global Positioning System technology leader, is selling at about 25 times this year's expected earnings and has been growing 20 percent a year. Dividing 25 (the P/E ratio) by its growth rate produces a P/E to earnings growth ratio (PEG) of 1.25. The PEG ratio for most value companies is closer to 2. This valuation measure has reversed since the late 1990s, when growth company PEG ratios were significantly higher than value company PEG ratios.

A look at previous economic cycles and comparative valuations indicates this is an excellent time to focus on growth investing. Over the past eight months, growth company indexes are up about 14 percent, substantially outperforming the popular stock market averages.

Given the attractive valuations in the growth sector, this period of outperformance by growth stocks may have just begun.

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